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No. 07-1061

In the Supreme Court of the United States

ESTATE OF JOSEPHINE T. THOMPSON, DECEASED, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, after concluding that the Commissioner bears the burden of proof under 26 U.S.C. 7491, and rejecting the valuation of property proposed by the Commissioner, the Tax Court is required to accept the valuation proposed by the taxpayer's expert even if the court concludes that the valuation is contradicted by other record evidence.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A13) is reported at 499 F.3d 129. The opinion of the Tax Court (Pet. App. A17-A79) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 23, 2007. A petition for rehearing was denied on November 14, 2007 (Pet. App. A81-A82). The petition for a writ of certiorari was filed on February 12, 2008. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. When Josephine T. Thompson died on May 2, 1998, she owned approximately 20% (487,440 shares) of

the stock of Thompson Publishing Company, Inc. (TPC). TPC, which was privately owned and closely held, published and sold business-to-business directories. TPC's stock had never been publicly traded, and there were no sales of the stock in the 10 years before Thompson's death. Pet. App. A2-A3, A17.

TPC described itself as "the acknowledged leader" in its field, having "by far the most complete and helpful specifying and buying guide published today." Pet. App. A21-A22 (quoting 22 *Thomas Register of American Manufacturers* 3573 (86th ed. 1996)). When Thompson died, TPC was regarded by some as holding an effective monopoly in the United States on business-to-business industrial and manufacturing print publications. *Id.* at A20-A21.

In 1993, TPC began offering business-to-business directories on CD-ROM. In 1995, TPC began making its directories available on the Internet. Pet. App. A3. TPC's management stated that its objective was "to secur[e] * * * a dominant position in the electronic interchange of information among industrial buyers and sellers comparable to that which it has enjoyed in the hard copy realm." *Id.* at A24; C.A. E.A. E648.[1] In 1997, TPC's president described its Internet activities as a "substantial success." *Id.* at E1087. By early 1998, TPC's web site was ranked sixth among business-to-business web sites in the United States. *Id.* at E975; Pet. App. A3.

Because of TPC's increasing focus on technology, between 1993 and 1997, the number of subscribers to its print products declined from 73,500 to 67,500, but the number of subscribers to its electronic products soared

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[1] The exhibit appendix in the court of appeals is cited as "C.A. E.A."

from 1000 to 575,000. Pet. App. A25-A26; C.A. E.A. E925. Similarly, between 1993 and 1998, TPC's subscription revenues fell from $14.9 million to approximately $14.1 million, but its advertising revenue, which was its primary revenue source, increased from $165 million to $258 million. Pet. App. A26-A27; C.A. E.A. E370, E407, E451, E519, E917-E918.

TPC had no long-term debt, and its net book value at the end of 1997 was approximately $150 million, almost all of which consisted of current assets, including a large portfolio of liquid short-term investments. Pet. App. A35, C.A. E.A. E108, E1285. TPC had a long history of paying substantial dividends, which TPC's management regarded as "sacrosanct" (*id.* at E1083) and planned to continue to pay. Pet. App. A37-A38; C.A. E.A. E1083, E1161. In the six years before Thompson's death, TCP paid dividends of more than $8 per share. Pet. App. A37; C.A. E.A. E203, E232, E249, E280, E313, E346, E384, E426, E471, E495. In the four years after her death, dividend payments totaled more than $4 per share. Pet. App. A37-A38.

2. On its federal estate tax return, Thompson's estate valued her shares of TPC at $1.75 million, or $3.59 per share, based on an appraisal by George E. Goerig, a tax lawyer who lived in Alaska. The estate hired Goerig to appraise the TPC stock and to represent the estate as administrator in order to shift the location of the tax audit from New York City to Anchorage, Alaska, where Goerig represented he would be able to obtain a more favorable valuation for the estate. Goerig retained, as his assistant, Paul M. Wichorek, an Alaskan accountant with limited valuation experience and no experience valuing companies involved in the Internet. Pet. App. A3,

A38-A39; C.A App. A118, A160-A161, A169-A170, A201-A202, A283-A284; C.A. E.A. E540.

Goerig's valuation was based on the capitalization of income method. He first determined TPC's average earnings for the prior five years, as reduced by an additional $10 million of technology costs above and beyond prior technology expenditures to reflect an anticipated increase in such expenses in future years; next he capitalized the earnings at a capitalization rate of 30.5% (12% of which reflected a special increase for risk presented by the Internet); and, finally, he calculated the estate's share of the resulting value and discounted it by 40% to account for the fact that the estate held a minority interest and by an additional 45% to account for the lack of marketability of the estate's shares. Goerig's valuation did not include any of TPC's "non-operating" assets, which the Commissioner's expert valued at more than $100 million. Pet. App. A4, A46-A54, A69; C.A. App. A124-A126, A614-A615.

The Commissioner valued the shares at $66.45 per share, a total of approximately $32 million, based on an appraisal prepared by Brian C. Becker, who appraised the shares using a market multiple and discounted cash flow approach. Because those methods inherently took account of the minority nature of the estate's interest, Becker did not apply a minority interest discount. In addition, Becker used only a 30% discount for lack of marketability. Pet. App. A4, A39-A40, A54-A65.

3. As relevant here, the Tax Court concluded that the estate's appraisal evidence "was to be treated as credible" (Pet. App. A46 n.6) under 26 U.S.C. 7491. That statute provides that the burden of proof on a factual issue relevant to the taxpayer's liability shifts from the taxpayer to the Commissioner if the taxpayer,

among other things, "introduces credible evidence" on the issue. 26 U.S.C. 7491(a). Accordingly, the court imposed the burden of proof on the Commissioner. Pet. App. A46 n.6.

Applying that burden of proof, the Tax Court conducted a thorough examination of the record and found that the appraisals of both the estate's experts and the Commissioner's expert were "deficient and unpersuasive." Pet. App. A65. The court noted that Goerig and Wichorek were "too inexperienced, accommodating, and biased in favor of the estate" (*id.* at A46), and the court found them "only marginally credible" and "barely qualified" to value a successful, well-established company with annual income in the millions of dollars (*id.* at A66). The court, however, agreed with Goerig's conclusion that the TPC stock should be valued using a capitalization-of-income approach, rather than the discounted cash flow approach or by comparison to the value of other companies, as proposed by the Commissioner's expert. *Id.* at A72-A73; compare *id.* at A54-A65 (describing approach of Commissioner's expert) with *id.* at A46-A54 (describing approach of estate's experts).

Accordingly, the Tax Court used the valuation proposed by the estate's experts as the starting point in determining the value of the shares. See Pet. App. A65-A77. The court then essentially made three adjustments to that valuation. First, the court determined that TPC's adjusted income should be capitalized at 18.5%, rather than 30.5%, because the record evidence did not support the 12% increase in the capitalization rate adopted by the estate's experts to reflect alleged risk posed by the Internet. *Id.* at A66-A68, A74. Second, the court determined that $68 million of non-operating assets should be included in determining TPC's overall

value. *Id.* at A69-A70, A74. Third, the court allowed only a 15% minority-interest discount and a 30% discount for lack of marketability, the percentage used by the Commissioner's expert. *Id.* at A74-A75. The court therefore valued the estate's stock in TPC at approximately $13.5 million, or $27.75 per share. *Id.* at A77.

4. The court of appeals upheld the Tax Court's valuation, except for one computational error acknowledged by both parties, and the court of appeals remanded the case for correction of that error. Pet. App. A1-A13. In so holding, the court of appeals rejected petitioners' contention that 26 U.S.C. 7491 required the Tax Court to accept the estate's valuation in full. Pet. App. A2, A6-A7.[2]

Petitioners argued that, because they had introduced some credible evidence of value, thereby shifting the burden of proof to the Commissioner, Section 7491 required the Tax Court to adopt, without any modification, the valuation proposed by the estate's experts, once the court had rejected the Commissioner's proposed valuation. See Pet. App. A2. The court of appeals held that Section 7491's allocation of the burden of proof "does not require the Tax Court to adopt the taxpayer's valuation, however erroneous, whenever the Court rejects the Commissioner's proposed value." *Id.* at A7. Instead, the court stated, the Commissioner can satisfy his burden of disproving the taxpayer's valuation "by evidence in the

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[2] Despite their contention that the Tax Court was required to accept the valuation of the estate's expert without modification, petitioners expressly stated in their brief to the court of appeals that they were not contesting either the Tax Court's allowance of a minority interest discount of only 15%, rather than the 40% used by the estate's experts, or the court's allowance of a marketability discount of 30%, rather than the 45% used by the estate's experts. Pet. C.A. Br. 7 n.1.

record that impeaches, undermines, or indicates error in [that] valuation." *Ibid.* That conclusion, the court reasoned, is consistent with the longstanding rule that the "Tax Court is not bound by the formulas or opinions proffered by expert witnesses" but "may reach a determination of value based upon its own analysis of all the evidence in the record." *Ibid.* (quoting *Silverman* v. *Commissioner*, 538 F.2d 927, 933 (2d Cir. 1976)).

In this case, the court of appeals observed, the Commissioner "not only presented evidence in support of his own valuation; he also cited record evidence to rebut the Estate's valuation, arguing that the Estate's profit projections were overly pessimistic, that it failed to properly account for non-operating assets, and that its assumptions about the Internet were inconsistent with the company's investments in Internet-related projects." Pet. App. A7. Accordingly, after concluding that the Tax Court's factual determination of the value of the stock was not clearly erroneous, the court of appeals affirmed the Tax Court's valuation in all respects, except for the computational error noted above. *Id.* at A8.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. The petition for a writ of certiorari should therefore be denied.

1. Petitioners renew their contention (Pet. 10-16) that 26 U.S.C. 7491 required the Tax Court to accept, without modification, the stock valuation proposed by the estate's experts once the court had concluded that the Commissioner bore the burden of proof and the court had rejected the Commissioner's proposed valua-

tion. The court of appeals correctly rejected that contention.

Section 7491 provides that, when a taxpayer introduces "credible evidence" on a factual issue relating to tax liability, and certain other requirements are met, the Commissioner "shall have the burden of proof with respect to such issue." 26 U.S.C. 7491(a). As the court of appeals correctly concluded, Section 7491's reallocation of the burden of proof "does not require the Tax Court to adopt the taxpayer's valuation, however erroneous, whenever the Court rejects the Commissioner's proposed value." Pet. App. A7. Nothing in Section 7491 alters the longstanding rule that, in determining the value of property for federal tax purposes, a court is not bound to adopt the valuation of either party's experts. See *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 295 (1938). On the contrary, the court "may reach a determination of value based upon its own analysis of all the evidence in the record." *Silverman* v. *Commissioner*, 538 F.2d 927, 933 (2d Cir. 1976); accord, *e.g.*, *Estate of Fitts* v. *Commissioner*, 237 F.2d 729, 732-733 (8th Cir. 1956).

As the court of appeals explained, although the Commissioner bore the burden of proving that the estate's proposed valuation was too high, he did not have to satisfy his burden by proving that his own expert's valuation was correct; instead, he could satisfy his burden "by evidence in the record that impeache[d], undermine[d] or indicate[d] error in the taxpayer's valuation." Pet. App. A7. That conclusion accords with the general rule that, "[i]n determining whether any fact has been proved," the fact-finder must "consider all of the evidence bearing on the question regardless of who introduced it." 7th Cir. Fed. Civil Jury Instruction 1.08; see,

e.g., *Fidelity & Cas. Co.* v. *Driver*, 79 F.2d 713, 714 (5th Cir. 1935). It also accords with the traditional rule in tax valuation cases that "[t]he fair market value of property * * * is a question of fact for the tax court to resolve considering *all* relevant evidence in the record." *Orth* v. *Commissioner*, 813 F.2d 837, 842 (7th Cir. 1987) (emphasis added); see *Silverman*, 538 F.2d at 933 (court's determination should be based on "*all* the evidence in the record") (emphasis added); 26 C.F.R. 20.2031-2(f) ("fair market value" depends on the "facts of each case"); Rev. Rul. 59-60, 1959-1 C.B. 237, 238 ("A sound valuation will be based upon all the relevant facts.").

As the court of appeals observed, the Commissioner "cited record evidence to rebut the Estate's valuation, arguing that the Estate's profit projections were overly pessimistic, that it failed to properly account for non-operating assets, and that its assumptions about the Internet were inconsistent with [TPC's] investments in Internet-related projects." Pet. App. A7. In light of that evidence and argument, the Tax Court correctly concluded that the Commissioner had proved that the valuation proposed by the estate's experts was "deficient and unpersuasive" in several critical respects. *Id.* at A65.

The Tax Court found essentially three errors in the estate's experts' valuation: first, the estate's experts had incorrectly added 12 percentage points to the rate used to capitalize TPC's income to reflect the risk posed by the Internet; second, they had incorrectly failed to include $68 million of non-operating assets in determining TPC's value; and, third, they had incorrectly applied a 40% minority-interest discount and a 45% lack-of-marketability discount. Pet. App. A65-A77. Contrary to pe-

titioners' suggestions that there was no record evidence to support those findings, there was ample evidence, including evidence introduced by the Commissioner.

As the Tax Court explained, its rejection of the 12 percentage point adjustment for Internet risk was supported by extensive evidence showing that, "while the Internet posed certain risks to TPC, the Internet also provided significant new business and financial opportunities." Pet. App. A66. Indeed, at the time of Thompson's death, "TPC appeared to be well situated on the Internet, and TPC's future as to its Internet operations appeared good." *Id.* at A66-A67. That view was repeatedly stated by TPC's management and supported by the testimony of the Commissioner's expert. See *id.* at A24, A66-A67; C.A. E.A. E648, E1087, E1212. It was also supported by TPC's operating results in the years preceding Thompson's death, during which subscriptions to TPC's electronic products and TPC's advertising revenues from those products both increased substantially. See Pet. App. A25-A27; C.A. E.A. E370, E407, E451, E519, E917-E918, E925.

The Tax Court's decision to reduce the capitalization rate was also supported by TPC's long history of paying substantial cash dividends, which the evidence showed was likely to continue. See Pet. App. A37-A38, A67; C.A. E.A. E1083, E1161. Indeed, in the six years preceding Thompson's death, TPC paid dividends per share equal to twice the per-share valuation proposed by the estate's experts. And, in the four years after Thompson's death, TPC again paid dividends per share that exceeded the per-share valuation. See Pet. App. A37-A38; C.A. E.A. E203,E232, E249, E280, E313, E346, E384, E426, E471, E495. Thus, the Tax Court was amply justified in concluding that the capitalization rate used by the estate's

experts was excessive and reflected their bias and lack of experience in evaluating the effect of the Internet and other technologies on the value of a company. Pet. App. A46, A47, A66; see C.A. App. A169-A170, A201-A202.

The Tax Court's decision to include $68 million in non-operating assets in TPC's valuation was also well supported by the evidence, including the testimony of the Commissioner's expert. He testified that TPC's non-operating assets, *i.e.*, those that TPC was not using to finance its "day-to-day operations," amounted to over $100 million, including cash-on-hand and short-term investments. C.A. App. A614-A615. The Tax Court included only the $68 million in short-term investments, agreeing with petitioners that TPC's cash-on-hand should be treated as an operating asset because it was needed to run the business. Pet. App. A69-A70. That was an extremely conservative estimate of TPC's non-operating assets, amounting to only 37% of TPC's current assets. See C.A. E.A. A108, A1285.

The Tax Court's rejection of the 40% minority interest discount and 45% discount for lack of marketability used by the estate's experts was also well grounded in the evidence. As the court explained, "[t]he experts for the estate selected discount rates that were extreme and highly favorable for the estate, without any credible substantive discussion of how the facts of this case support[ed] such particular discounts." Pet. App. A70. The Tax Court settled on a 20% minority-interest discount based on a review of the discounts used in other cases and an analysis of the estate's particular minority interest. See *id.* at A73-A75. After a similarly careful analysis of the facts, the court agreed with the Commissioner's expert that the discount for lack of marketability should be no higher than 30%. See *id.* at A75. In

their opening brief in the court of appeals, petitioners essentially conceded that the Tax Court was justified in rejecting their proposed discounts, stating that "[t]he Estate is not seeking review of those findings." Pet. C.A. Br. 7 n.1. In light of that concession, petitioners' contention that the Tax Court was nonetheless required by Section 7491 to accept their experts' valuation without any modification is simply untenable.

2. Petitioners also err in contending (Pet. 16-19) that the decision below conflicts with decisions of other courts of appeals. Indeed, none of the cases cited by petitioners even addressed whether Section 7491 requires a court to accept the taxpayer's valuation when the court concludes that the Commissioner bears the burden of proof and the court rejects the Commissioner's valuation.

Caracci v. *Commissioner*, 456 F.3d 444 (5th Cir. 2006), did not involve Section 7491 at all. Instead, *Caracci* involved the entirely different rule, based on case law, that the Commissioner bears the burden of proving a taxpayer's actual tax liability once the taxpayer has established that the original assessment was arbitrary and erroneous. See *id.* at 457. In *Caracci*, the court of appeals held that the Tax Court committed error because it "did not place the burden of proof on the Commissioner" but instead expressly declined to decide which party had the burden. *Ibid.* Here, in contrast, the Tax Court expressly placed the burden of proof on the Commissioner. Pet. App. A46 n.6. Moreover, in *Caracci*, the court of appeals rendered judgment for the taxpayer because the court concluded that "the record [made] it clear that the Commissioner [could not] meet his burden of proof." 456 F.3d at 462. In contrast, in this case, as the court below held, the Tax Court cor-

rectly found, based on all the evidence in the record, that the Commissioner proved that the estate's stock had a value of $13.5 million, based on the valuation methodology used by the estate's experts, as corrected to eliminate the effect of the experts' errors, bias, and inexperience.

Griffin v. *Commissioner*, 315 F.3d 1017 (8th Cir. 2003) (per curiam), involved Section 7491, but the court of appeals did not address whether the Tax Court must accept the taxpayer's valuation without modification if the court concludes that the Commissioner has the burden of proof and the court rejects the Commissioner's valuation. *Griffin* held only that, under the facts of that case, the taxpayers had introduced sufficient "credible evidence" to shift the burden of proof. *Id.* at 1022. To the extent that *Griffin* is relevant to the question decided by the court below, *Griffin* supports the court's decision. The court in *Griffin* emphasized that the determination whether a taxpayer had provided "credible evidence" should be made as "*if no contrary evidence were submitted.*" *Id.* at 1021. And, upon concluding that the taxpayers had presented credible evidence, the court of appeals remanded the case for the Tax Court to determine, based on "all of the evidence properly before it," "whether the Commissioner has met his burden of proof." *Id.* at 1022.

Morrissey v. *Commissioner*, 243 F.3d 1145 (9th Cir. 2001), and *Estate of Simplot* v. *Commissioner*, 249 F.3d 1191 (9th Cir. 2001), have virtually nothing to do with the issue presented in this case. In *Morrissey*, the court of appeals held that, on the evidence presented, actual arm's length sales of stock were more persuasive evidence of value than the Commissioner's estimate of the stock's value. 243 F.3d at 1147-1148. In *Estate of Sim-*

plot, the court of appeals rejected the Tax Court's conclusion, on the facts of the particular case, that the value of an estate's minority stock interest should be increased to reflect its supposed voting power. 249 F.3d at 1195-1196. The court of appeals did not cite Section 7491 in either case, much less address the issue decided by the court below.

JPMorgan Chase & Co. v. *Commissioner*, 458 F.3d 564 (7th Cir. 2006) (*JPMorgan*), also did not involve Section 7491. Instead, *JPMorgan* turned on a different statute, 26 U.S.C. 446, which prescribes the method of accounting for taxable income. Section 446 provides that taxable income shall be computed using the method of accounting that the taxpayer regularly uses to keep his books, but, if that method does not "clearly reflect income, then the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner,] does clearly reflect income." 26 U.S.C. 446(b). The court of appeals held that, once the Tax Court determined that the taxpayer's method of accounting for interest swaps did not clearly reflect income, Section 446(b) required the Tax Court to use the method proposed by the Commissioner unless that method was "clearly unlawful" or "plainly arbitrary." *JPMorgan*, 458 F.3d at 570 (citation omitted). The court of appeals' interpretation of Section 446 has little, if any, bearing on how to interpret the entirely different statute at issue in this case.[3]

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[3] Petitioners also mistakenly contend (Pet. 20-22) that this Court should grant the petition for a writ of certiorari to resolve a conflict between the decision of the court below and two Tax Court decisions, *Kohler* v. *Commissioner*, 92 T.C.M. (CCH) 48 (2006), nonaq., 2008-9 I.R.B. 482, and *Forste* v. *Commissioner*, 85 T.C.M. (CCH) 1146 (2003). A purported conflict between the decision of a court of appeals and trial

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 2008

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court decisions is not a basis for review by this Court. See Sup. Ct. R. 10. In any event, neither *Kohler* nor *Forste* applied a rule that, whenever the Tax Court concludes that the Commissioner bears the burden of proof on valuation of property under Section 7491, the court must accept the taxpayer's valuation, however erroneous, once the court has rejected the valuation proposed by the Commissioner. In *Kohler*, for example, the Tax Court carefully scrutinized the valuation of the taxpayer's experts, whom it found "thoughtful and credible." 92 T.C.M. (CCH) at 56. The court accepted the taxpayer's proposed valuation only "[a]fter carefully reviewing and considering *all* of the evidence." *Ibid.* (emphasis added).